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TAGS: ETRD ECON ELAB IT CH EXPORT CONTROLS
SUBJECT: ITALY'S TRADE AND INVESTMENT RELATIONS WITH CHINA: THREAT OR OPPORTUNITY?

Refs: A) Florence 13; B) 2004 Beijing 19943

Summary

¶1. There are divided views in Italy on trade and investment in China and whether China is a threat or an opportunity. Although Italian exports to China have increased recently, they pale compared to the sharp increase of Chinese imports into Italy. Italy's direct investment in China remains quite small. Those GOI officials and Italian manufacturers that view China as a threat point primarily to China's unmatchably low labor costs, the strength of the Euro, Italy's weak economy, and the lack of strong Italian investment in China as root causes of their anxiety. This fear of China has caused some Italian manufacturers to push for protectionist actions against Chinese products, especially after the recent expiration of the WTO Agreement on Textiles and Clothing. Alongside such concerns, other Italian companies believe China's growing economy represents an important opportunity to expand trade and investment. Chinese competition may not pose a significant threat to most Italian companies, but in several/regions (for example, textiles in Tuscany), the effects of Chinese competition are significant and it has fostered a sense of crisis within the business community. More broadly, certain Italian SMEs will suffer from Chinese competition if they do not adapt to an increasingly competitive international market. Because of Italy's electoral timetable over the next year, politicians will continue to generate a lot of noise and smoke about the "China threat," but this will translate into little action, given the constraints of Italy's EU obligations. End summary.

Italy-China Trade -- The GOI's Dueling Views

¶2. In recent months, the Italian Government has ratcheted up its attention to Italy's trade relationship with China as never before, most publicly with the visit of President Ciampi to China in December 2004. Accompanied by Foreign Minister Fini, Finance Minister Siniscalco, and Productive Activities Minister Marzano, Ciampi emphasized commercial opportunities for Italian firms during the visit, as strongly evidenced by some 200 Italian business representatives that accompanied him. During his visit, Ciampi signed eight commercial accords with Chinese President Hu Jintao, including agreements on restriction-free exports of Italian processed meats to China; the proclamation of 2006 as the "Year of Italy in China;" and joint cooperation in preparation for the 2006 Winter Olympic Games in Turin (Ref B). China reportedly had never before recognized a foreign Olympic committee as a viable partner for cooperation in preparation for the Olympic games. Ciampi's visit came towards the end of the yearlong "Marco Polo Project," a calendar of events organized by Italian trade officials to promote greater Italian investment in China in 2004.

¶3. China was also the focus of the Second National Foreign Trade Conference, on February 26, 2005, which featured Prime Minister Berlusconi, along with Fini, Marzano, Foreign Trade Vice Minister Urso, and other leading government and business figures. In contrast to Ciampi's emphasis on China as an opportunity for Italian business seeking trade and investment abroad (and thus a means to help bolster Italy's lackluster economy), the February trade conference focused more on the potential threat China poses to Italy's export-dependent economy, especially in the textile sector. Several speakers noted that China's reputation as a golden opportunity for foreign investors was overstated; and the prevailing view among the many Italian manufacturers present was that, in the near to medium term, China represented more of a threat to them than an opportunity. Just one week after the conference, Marzano and Urso announced that the GOI would ask the European Commission to impose safeguard measures, including antidumping duties, to counter the "predatory invasion" of Chinese textiles into Italy in

recent months.

¶4. Italian industry views of China vary as much as those

within the GOI. Some Italian SMEs express concern that Chinese goods flooding both domestic and foreign markets will displace Italian goods. At the same time, many Italian firms, including some that worry about Chinese exports, wish to reap the benefits of the ever-growing Chinese economy. Italy's export finance company (SACE, akin to the QS. Export-Import Bank) lies firmly in the pro-opportunity-in-China camp.

Italy-China Trade and Investment Figures

¶5. Italy's exports to China in 2004 were valued at Euro 4.4 billion, placing Italy third within the EU, after Germany and France. More than half of Italian exports to China are machinery-based, and the remainder includes high technology medical equipment, iron, and steel. In terms of imports, Italy is China's fourth largest market in the EU (Euro 11.8 billion in 2004). Italy's principal imports from China include textiles, household equipment, and machinery parts. Italy's 2004 trade deficit with China equaled 7.4 billion Euro. Although Italian exports have increased in all but one of the last six years, Chinese imports have risen by much higher percentages during this same period.

Italy's Foreign Trade with China (billions of Euro)

	Imports	Exports	Balance
1999	5.0	1.8	-3.2
2000	7.0	2.4	-4.6
2001	7.5	3.3	-4.2
2002	8.3	4.0	-4.3
2003	9.6	3.9	-5.7
2004	11.8	4.4	-7.4

¶6. Recent statistics on Italian exports to China could be viewed positively, especially given the rise of the euro against the Chinese yuan. However, many companies, especially the small-to-medium-sized manufacturers that constitute roughly 90 percent of all Italian enterprises, are blaming China for their loss of market share in both Italy and abroad in recent years. In 2003, Italy's export-dependent economy weathered a 3.9 percent decline in all exports, though exports rebounded in 2004 with a 5.7 percent increase. Despite this positive 2004 data, the sectors of textiles and clothing, furniture, leather and footwear registered significant decreases in exports during the year.

¶7. In terms of foreign direct investment, Italy is currently ranked fifth among European countries and 19th among all foreign investors. According to the latest statistics, Italy's cumulative investment in China was about USD 230 million as of September 2003, amounting to only 0.3% of worldwide investment in China. Most investment during 2003 was in the automobile, textile, mechanical equipment, and pharmaceutical sectors.

Euro's Strength Versus the Dollar and the Yuan

¶8. The strong euro gives Chinese companies a key advantage over Italian firms when exporting to foreign markets, especially the United States. Italian government representatives believe Italy's unfavorable exchange rate vis--vis the yuan (which is pegged to the dollar) has led to growing Chinese competition in the foreign export sector (Ref A). Some experts calculate that certain Italian export sectors suffered as much as 20 percent from 2003-2004, due solely to the euro's strength against the yuan.

Promoting Labels of Origin/"Made in Italy" Brand

¶9. In response to anxiety over Chinese exports flooding global markets, more Italian SMEs are working together to strengthen the competitiveness of Italian goods. One idea advocated by some Italian SMEs, and backed by Italian trade officials, would require all nations to label the origin on the textiles they produce. This information would

theoretically encourage consumers to buy Italian products due to their high quality reputation, compared to those of other nations, including China. In addition, there is a campaign within Italy to promote the "Made in Italy" brand by placing it on more Italian products, again relying on the reputation of high-quality Italian goods to increase Italian exports. This emphasis on labeling is also a reflection of widespread Italian views that Chinese exports are pirated,

and thus unfair competition.

WTO Agreement's Demise Raises Strong Concerns

¶10. No single recent event has preoccupied Italian exporters and trade officials more than the termination of the multilateral WTO Agreement on Textiles and Clothing (which replaced the earlier Multifiber Arrangement ending in 1994). This termination is widely believed to pose a serious threat to Italian manufacturers. Rossano Soldini, president of the Italian footwear manufacturers' association, recently claimed that footwear imports from China rose 45 percent in the past three years and reached 150 million pairs in 2004. He predicts a further increase to 300 million pairs this year.

¶11. Textile manufacturers are equally worried, particularly in Tuscany, where the province of Prato is Italy's largest producer of fabrics. In the last ten years, the district has lost 30 percent of its manufacturing companies, while imports of fabrics and apparel from China increased six times, increasing in value from euro 23 million in 1994 to 122 million in 2003. According to the Prato manufacturers' association and Chamber of Commerce, large illegal imports of counterfeited textile products from China also add to the industry's problems. As a consequence, Prato's per capita income, in real terms, declined 0.4 percent each year between 1996 and 2003 (though there was some increase in the city's population at the same time, mostly due to immigration). A recent study of the University of Florence predicts a further 25 percent decline in the number of local textile manufacturers in the next two/three years.

¶12. The Italian textile and footwear industries believe that the only way to compete with Chinese manufacturers is to continue to rely on the reputation and quality of Italian brand-name products. SACE's chief economist, Alessandra Lanza, believes Italian SMEs can maintain superior quality through consolidation, allowing several SMEs to use their combined resources to make joint investments in product research. Similarly, Francesco Pensabene, economic expert at the Asia-Oceania desk of the "Istituto Nazionale per il Commercio Estero" (ICE: Italy's foreign trade promotion agency, roughly equivalent to the U.S. Foreign Commercial Service), told us that simply maintaining current quality standards is not sufficient for Italy's exports to maintain or increase their current levels. Rather, Italian companies need to invest in more research and development to create higher quality products.

.But Not All Italian Companies Fear China.

¶13. Despite strong concerns about Chinese competition and the lack of Italian investment in China, many Italian companies are trying to take advantage of China's growing economy by promoting their products in China. As discussed above, some hope promoting the "Made in Italy" brand could increase Italian market share in China beyond textiles and machinery into other sectors, such as high technology equipment. ICE's Pensabene notes that Italian firms could benefit very much by taking advantage of the growing consumer awareness of the Chinese middle class. This group, he maintains, views Italy as a nation of cultural and manufacturing excellence, and desires many Italian products, including furniture, kitchenware, fashion, food, and products featuring Italian design. Pensabene also believes the Italian tourist sector is poised to attract much larger numbers of Chinese tourists in the near future. According to some polls, 70 percent of Chinese who want to come to Europe would choose Italy as their destination. Chinese tourism should bring a significant increase in direct revenue to the Italian economy, while further stimulating the Chinese desire for Italian exports.

Italian Investment in China - A Weak Relationship

¶14. Pensabene believes Italians have so far been unwilling to take the risk of large investments and that Italy's relative lack of investment in China could have lasting repercussions on Italy's economy. Pensabene identified two obstacles to Italian investment in China:(a) lack of financial resources, and (b) an "export-only" mentality that keeps Italian firms from creating sales and service networks abroad.

Lack of Financial Resources

¶15. Pensabene told us that Italian SMEs find it difficult to acquire capital to invest in China for two reasons. First, Italian SMEs, many of which are family-owned, tend to be

reluctant to seek outside financing for fear of giving up control of their companies. Second, many Italian banks are overly risk-averse, thus unwilling to extend credit for investment in China where success appears uncertain. (According to SACE's Lanza, Italian SMEs prefer to invest in small markets close to home, such as Eastern Europe, an area also considered less risky than China. These SMEs do not have to consolidate to invest in Eastern Europe and do not need as much initial capital to start a business there.)

¶16. Despite this difficulty, SIMEST (the Italian government agency that lends to Italian companies wishing to invest abroad, similar to the U.S. OPIC) helps Italian companies in every step of setting up business in China, from making equity investments to developing industrial relations with foreign partners. SIMEST Director of Area Participation and Finance, Gerardo Stigliani, told us that the agency currently ranks China as its number one priority in terms of investment aid to companies. SIMEST gives out more than 40 million euro yearly for projects in China, mostly for engineering, construction, and clothing projects.

"Export-only" Mentality

¶17. Pensabene argues that Italian companies should make long-term investments abroad and not rely merely on quality and brand recognition to increase market share. He noted Italian firms do not always appreciate the need for investment to support exports. For example, a Chinese Fiat owner, Pensabene maintained, often must wait weeks for parts to arrive from Turin because the Italian car maker has not built a sufficient parts and service network in China. Fiat and other Italian firms are also hampered in international markets, including China, by a reluctance to transform research and development into new technologies, he said. Note: we understand Fiat's truck division is doing well in China, but its auto sector is in trouble (not unlike the company's situation in Europe). End Note.

Two Success Stories

¶18. There are close to 500 Italian companies in China, excluding those in Hong Kong. Many are Italian/Chinese joint ventures, mostly in the areas of telecommunications (nineteen percent), automotive products (sixteen percent), and chemicals and petrochemicals (nine percent). Two examples of Italian companies that have been quite successful in opening manufacturing facilities in China are Geox (footwear manufacturer) and De Longhi (manufacturer of small appliances and heating systems). Both have opened factories in China, with De Longhi also closing down several factories in Italy to relocate production in China - but at the cost of more than 650 Italian jobs and several labor protests in 2004.

Comment

¶19. China's rise as a global economic power, based on low-cost manufacturing capabilities, has provoked considerable hand-wringing in Italy. Much of this concern, however, can be attributed to a widespread anxiety here that Italy is in economic decline. The World Economic Forum's 2004 Competitiveness Report, for example, ranks Italy a dismal 47th globally, the lowest by far of the G7 economies. Under the Berlusconi government, in office since mid-2001, Italy's annual GDP growth rate has been only 0.9 percent. Contrasted with China's booming economy, Italy's economic malaise appears all the more pronounced.

¶20. Looked at dispassionately, however, there is little evidence to suggest that China poses a direct threat to the vast majority of Italian businesses, especially those whose success has been built upon the high-quality and high-brand recognition products for which Italy is famous. However, those businesses that compete more upon price than quality - such as the lower ends of the textile, apparel and shoe industries -- will likely continue to suffer. Moreover, Italian family-owned SMEs in such sectors may have a particularly difficult time adapting to new market realities.

¶21. The GOI's ability to react against the "China threat," even in those limited areas where it actually exists, is of course severely constrained by Italy's obligations within the European Union. This, however, will not prevent Italian politicians from continuing to make a great deal of noise on this issue, given the country's electoral calendar: regional election take place in early April; national elections loom in the first half of 2006. The Northern League party, a junior partner in the governing coalition, for example has seized upon the Chinese threat to Italy's textile sector as a prime vote-attracting issue (the League

is strongest in the commercial heartland of northern Italy).
In the end, however, we anticipate such polemics will amount to just that: much smoke and noise, but little action. End comment.

¶22. This message was drafted by Embassy Rome Intern Jessica Alvarez.

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